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No. 97-1733

In the Supreme Court of the United States

OCTOBER TERM, 1997

WILLIAM SPEARS AND JOAN SPEARS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether, on the particular facts of this case, petitioners are liable for the negligence penalty imposed by Section 6653(a) of the Internal Revenue Code, 26 U.S.C. 6653(a) (1982).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-5a) is unreported, but the decision is noted at 131 F.3d 131 (Table). The opinion of the United States Tax Court (Pet. App. 6a-56a) is unofficially reported at 72 T.C.M. (CCH) 223.

JURISDICTION

The order of the court of appeals was entered on November 24, 1997. On February 10, 1998, Justice Ginsburg extended the time for filing a petition for a writ of certiorari to April 23, 1998. The petition for a writ of certiorari was filed on April 22, 1998. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Section 6653(a) of the Internal Revenue Code imposes a penalty of five percent on any tax underpayment resulting from the "negligence" of the taxpayer. 26 U.S.C. 6653(a) (1982). The courts below concluded that, on the particular facts of this case, petitioners were negligent in the underpayment of their tax obligations.

1. a. On their income tax return for 1982, petitioners improperly claimed income tax deductions and credits from participation in a tax shelter scheme involving a limited partnership known as SAB Resource Recycling Associates (Pet. App. 21a). That partnership was formed to promote the plastics recycling tax shelter described in *Provizer* v. *Commissioner*, 63 T.C.M. (CCH) 2531 (1992), aff'd mem., 996 F.2d 1216 (6th Cir. 1993), cert. denied, 510 U.S. 1163 (1994).

This tax shelter scheme involved a series of simultaneous sales, leases and licenses of machines designed to recycle plastic scrap (Pet. App. 11a). Packaging Industries, Inc., manufactured and sold seven recycler machines to ECI Corp. for $981,000 each. ECI Corp. then resold the recyclers (receiving primarily nonrecourse notes) to F & G Corp. for $1,162,666 each. F & G Corp. then leased the recyclers to SAB Recycling, which licensed them to FMEC Corp. That corporation then completed the circle by sublicensing the recyclers back to their original manufacturer, Packaging Industries, Inc. The monthly payments required among the entities involved in these transactions precisely offset each other—no cash changed hands (*id.* at 12a, 13a & n.5). These circular transactions thus constituted a

classic sham and tax shelter scheme; they lacked any economic substance or business purpose *other than* the ostensible creation of tax deductions and credits. See *Provizer* v. *Commissioner*, 63 T.C.M. (CCH) at 2547-2553.

The prospectus for the tax shelter scheme contained direct warnings of the tax risks presented by these sham transactions (J.A. 406):

> AN INVESTMENT IN THE PARTNERSHIP INVOLVES A HIGH DEGREE OF BUSINESS RISK AND SOME TAX RISKS AND SHOULD, THEREFORE, BE CONSIDERED ONLY BY PERSONS WHO * * * CAN AFFORD TO LOSE ALL OF THEIR CASH INVESTMENT AND SOME OF THEIR ANTICIPATED TAX BENEFITS.

The prospectus emphasized that the partnership had no operating history and that there was no established market for the recycling machines (Pet. App. 15a, 40a). As the trial court stated (*id.* at 40a-41a):

> A careful consideration of the materials in the respective offering memoranda * * * should have alerted a prudent and reasonable investor to the questionable nature of the promised deductions and credits. * * * According to the offering memoranda, for each $50,000 investor, the projected first-year tax benefits were investment tax credits in excess of $82,500 plus deductions in excess of $40,000. * * * As a result of Spears' $25,000 investment in SAB Recycling, he and his wife Joan claimed an operating loss in the amount of $19,870 and investment tax and business energy credits totaling $41,320.

> The direct reductions claimed * * * from the investment tax credits alone, ranged from 165 to 167 percent of their cash invesments * * * .

The prospectus directly warned participants that, in view of the sizeable tax benefits claimed, the Internal Revenue Service would probably audit the income tax returns of the partnership and its partners (*id.* at 15a, 40a).

A tax opinion prepared by an attorney was attached to the prospectus (J.A. 296-365). The attorney acknowledged that he lacked a technical background and did not have a good understanding of engineering or of the development and design of the recycling machine (J.A. 1585). His tax opinion was addressed to the general partner of SAB Recycling, Stuart Becker. The opinion stated that it was for the "individual guidance" of Mr. Becker and that investors should rely on their own advisors (Pet. App. 42a; J.A. 296).[1] As the attorney explained at trial, his opinion "never passed on the fair market value of * * * the machine" (J.A. 1586). The tax opinion merely cited "[t]he written evaluation of the Sentinel Recyclers furnished to the Partnership by one Evaluator [who] concludes that the purchase price to be paid by F & G therefor is fair and reasonable" (J.A. 544).[2] Although the attorney

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[1] The prospectus also warned participants that its contents should not be considered to constitute expert advice and that each participant should consult his own professional advisors (J.A. 407).

[2] The evaluator referenced in the attorney's opinion was Stanley M. Ulanoff, a Professor of Marketing at City University of New York (J.A. 595). His "evaluation" consisted primarily of a discussion of the need for plastics recycling (J.A. 594-603). He did not do a marketing analysis and did not analyze the costs or anticipated revenues from the recyclers.

concluded that the tax benefits sought by the partnership would probably be achieved, his opinion emphasized that "the Service is not bound by and may challenge the conclusions reached in such report" (*ibid.*).

b. Petitioner William Spears received a B.A. degree with honors in 1960 from Princeton University and a graduate degree with distinction in 1962 from Harvard Business School. He has been an investment advisor for many years (Pet. App. 19a). He began his career at Loeb, Rhoades & Co. in 1962, where he became a general partner prior to his departure in 1971. In 1972 he formed his own firm—W.G. Spears, Inc.—to manage funds for wealthy individuals, pension funds, endowment funds and foundations (*ibid.*). The successor to that firm—Spears, Benzak, Solomon & Farrell—managed $1.5 billion in the mid-1980's and nearly $3 billion by 1994 (J.A. 1397; Pet. App. 20a). The focus of the work of his firm is to analyze the advice of experts in various fields before investing its clients' money (Pet. App. 23a).

Spears learned of the plastics recycling tax shelter from Stuart A. Becker, an accountant and tax specialist he first met in the mid-1970's (Pet. App. 22a). Between 1980 and 1982, approximately 60% of the practice of Becker's accounting firm involved tax-advantaged investments (*id.* at 16a). During 1981,

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Indeed, he did not refer in his "evaluation" to the ostensible purchase price ($1,162,666) of the recycler involved in this tax shelter scheme and, so far as can be determined from reviewing his report, was unaware of it. Another purported "evaluator" was a mathematics professor named Samuel Burstein. He concluded only that the equipment was operationally reliable. He did not purport to determine the value of the equpment (Pet. App. 14a; J.A. 623).

Becker investigated the plastics recycling tax shelter (*id.* at 20a). He reviewed the offering memorandum, and visited the plant where the recyclers were made in Hyannis, Massachusetts (*id.* at 17a). Becker, who did not have an engineering background and was not an expert in plastics materials or plastics recycling, did not hire experts in these fields to advise him (*id.* at 15a, 17a).

Becker formed six SAB recycling partnerships to serve as vehicles for his clients to invest in the Sentinel EPE recycler (Pet. App. 13a).[3] SAB Management Ltd. was the sole general partner of these partnerships and, in that capacity, received fees of approximately $500,000.[4] Becker's accounting firm also received fees for preparing the partnership returns and Forms K-1 for the SAB recycling partnerships (*id.* at 14a).

Becker retained the law firm Rabin & Silverman to assist him with the legal aspects of organizing the recycling partnerships and to advise him regarding disclosure obligations under the securities laws (Pet. App. 17a-18a, 35a). Michael D. DiGiovanna, the partner who advised Becker, had no education or experience in plastics recycling and was not responsible for (and did not obtain) independent verification of any of the representations in the offering materials (*id.* at 18a).

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[3] "SAB" is an acronym that stands for Stuart A. Becker (J.A. 1474).

[4] SAB Management Ltd. is wholly owned by Scanbo Management Ltd. (Scanbo), which is wholly owned by Becker. "Scanbo" is an acronym for Becker's three children—Scott, Andy, and Bonnie (Pet. App. 13a & n.6).

Becker recommended to clients such as Spears that they roll over their distributions from prior tax shelters into a recycling partnership (Pet. App. 20a, 22a-23a). Becker informed his clients of the limited scope of his investigations into the plastics recycling tax shelter scheme (*id.* at 38a):

> I don't recall saying to a client I did due diligence * * * [Rather,] I told [my clients] precisely what I had done to investigate or analyze the transactions. I didn't just say I did due diligence, and leave it open for them to define what I might or might not have done.

Adopting Becker's recommendation, Spears rolled over his distribution from a prior tax shelter to the plastics recycling partnership in 1981 (Pet. App. 20a-23a). Spears made an additional investment of $25,000 in the plastics recycling tax shelter in 1982 (*id.* at 21a, 23a). Spears did not seek independent expert advice on the investment; nor did he bring his firm's resources to bear in investigating it (*id.* at 23a). Although he knew that Becker was not an expert in plastics recycling, he did not inquire whether Becker had sought any independent expert advice (*ibid.*). Spears did not claim that he had reviewed or relied on the tax opinion attached to the prospectus. He testified that Becker's recommendation weighed more heavily with him than anything in the prospectus (J.A. 1479). Spears acknowledged that tax benefits were a primary consideration in his decision to invest in a recycling partnership (Pet. App. 22a). He was concerned that he would have taxable income to report from termination of a prior tax shelter in which he had invested and wanted to use tax credits

from the plastics recycling tax shelter to offset the resulting tax liability (*id.* at 23a).

Petitioners, who had a gross income in excess of $700,000 in 1982, claimed tax credits of $41,320 and operating losses of $19,870 from their $25,000 investment in the recycling tax shelter scheme in that year (Pet. App. 20a-21a). The investment tax credits were based on an alleged value of $1,162,666 per recycler (*id.* at 43a). Even setting aside the other claimed tax benefits from the recycling tax shelter, the investment tax credits alone constituted an immediate return of 165% of petitioners' cash investment in the scheme (*id.* at 41a). The Commissioner disallowed the claimed tax benefits and asserted that petitioners were liable for penalties for negligence (26 U.S.C. 6653 (1982)) and for valuation overstatement (26 U.S.C. 6659 (1982)).

2. Petitioners sought review of the Commissioner's determinations in Tax Court. Prior to trial, petitioners stipulated that the tax shelter transactions lacked economic substance and that the fair market value of the recyclers in 1982 did not exceed $50,000 (J.A. 956; Pet. App. 26a, 43a). They therefore conceded that they were not eligibile for the operating loss deductions and tax credits that they had claimed on their return (Pet. App. 10a). They continued to assert, however, that they were not liable for the negligence penalty for claiming these improper deductions and credits.

The Tax Court sustained the imposition of the negligence penalty and rejected petitioners' assertion that they had reasonably relied on expert advisors to determine the value of the recyclers (Pet. App. 26a-

47a).[5] The court concluded that the express warnings in the prospectus concerning the tax risks, and the implausibly disproportionate tax benefits of the shelter scheme, would have alerted any prudent investor to the questionable nature of the project (*id.* at 40a-41a). The court further noted that petitioner's "education and professional experience, and portions of [his] own testimony," showed that he "clearly knew better than to rely upon a person for advice on matters beyond his or her expertise" (*id.* at 33a).

3. The court of appeals affirmed (Pet. App. 1a-5a). The court agreed with the Tax Court that "[t]he high tax benefits projected in the prospectus * * * should have alerted the taxpayers to the questionable nature of the scheme" (*id.* at 3a). The court emphasized that petitioner, who was "a highly educated businessperson [and] a partner in an investment management firm," "could not abrogate [his] duty to verify the economic viability of the venture and the value of the business' central asset" (*ibid.*). The court concluded that petitioners could not reasonably rely on a tax advisor who they knew lacked expertise in plastics and in recycling and had a financial stake in promoting the shelter (*id.* at 4a).

ARGUMENT

The petition in this case presents the same factual questions concerning the negligence of taxpayers who participated in the plastics recycling tax shelter scheme that are presented in *Bennett* v. *Commissioner*, 131 F.3d 130 (2d Cir. 1997) (Table), petition for

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[5] The courts below also sustained the imposition of the Section 6659 penalties. Petitioners do not challenge that determination.

cert. pending, No. 97-1717.[6] Here, as in *Bennett*, the court of appeals relied on a number of factual determinations in sustaining the imposition of the negligence penalty. The court of appeals did not hold, as petitioners erroneously assert (Pet. 11), that the negligence penalty was imposed solely because the taxpayer's advisors were not expert in the particular technology underlying the investment. Instead, the court held that petitioners could not reasonably have relied on Becker, their tax advisor, because of (i) Becker's financial stake in promoting the shelter, (ii) his lack of expertise in plastics and his failure to hire persons who were actually expert in this field, (iii) his failure to verify the value of the recyclers and (iv) his reliance on biased representations of various interested persons (Pet. App. 3a-4a). The court also rejected the reasonableness of purported reliance on an advisor who ignored the warnings contained in the offering materials (*ibid.*).

For the reasons set forth in detail in the brief filed in opposition to the petition for a writ of certiorari in *Bennett*, review of these factual determinations "concurred in by two lower courts" is not warranted. See, *e.g.*, *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985), quoting *Rogers* v. *Lodge*, 458 U.S. 613, 623 (1982).

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[6] A copy of the brief filed in opposition to the petition for a writ of certiorari in that case has been supplied to counsel for petitioners in this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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